

DIRECT TESTIMONY

of

LAWRENCE R. KUNKEL

for

ISLAND HI-SPEED FERRY, LLC

**Regarding the Appropriate Form of Regulation for
Island Hi-Speed Ferry, LLC**

DOCKET NO. 3495

May 30, 2003

1 Q1. Mr. Kunkel, would you please provide your full name and address?
2
3 A1. Yes, its Lawrence R. Kunkel and I reside at 83 North Pearson Drive, Warwick, RI
4 02888.
5
6 Q2. With whom are you employed?
7
8 A2. I am President and Chief Economist of Kunkel Strategic Services, an economics and
9 strategic management consulting firm.
10
11 Q3. Would you please describe your educational background?
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13 A3. I hold an undergraduate degree in economics from Providence College and a graduate
14 degree in economics/social science from The University of Chicago. While at The
15 University of Chicago, I spent three years as the Research Assistant to George J.
16 Stigler, the 1982 Nobel Laureate in Economic Science and the Charles R. Walgreen
17 Distinguished Service Professor in the Graduate School of Business. During my
18 graduate studies at The University of Chicago, I also had the opportunity to study
19 under several other Nobel Laureates.
20
21 Q4. Is Exhibit A, attached hereto, a true and accurate copy of your Statement of
22 Credentials?
23
24 A4. Yes, it is.
25
26 Q5. Would you please highlight your professional accomplishments?
27
28 A5. I am a classically trained Economist with 24 years of experience in the areas of
29 antitrust, finance, strategic planning, economic research, economic development and
30 business strategy. I served as the Economist and Antitrust Officer for the Federal
31 Home Loan Bank of Chicago, the Senior Economist and Investment Strategist for
32 New York Life Insurance Company, the Director of Strategic Planning and Economic
33 Research for the Gilbane Building Company, the Managing Director for Economic
34 and Business Strategy for Ryan Edwards Global Strategic Services and the Executive
35 Director of the Central Rhode Island Development Corporation. For the last 7 years, I
36 have also served as the President and Chief Economist for Kunkel Strategic Services.

1 Q6. Have you been qualified and have you testified as an expert in previous DPUC and
2 RIPUC dockets?

3
4 A6. Yes, I have testified as an expert in the areas of economics, financial analysis and
5 market structure in Division Docket 98-MC-16 and in Commission Docket 2802.

6
7 Q7. What is the purpose of your testimony in this docket?

8
9 A7. Island Hi-Speed Ferry (IHSF) has requested that I provide testimony presenting my
10 expert economic opinion as to the appropriate form of regulation for its entity.

11
12 Q8. Are there forms of regulation which in your expert economic opinion are not
13 appropriate for IHSF?

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15 A8. Yes, two.

16
17 Q9. What are these inappropriate forms of regulation that you are not recommending?

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19 A9. The two are complete deregulation and rate-based, rate of return.

20
21 Q10. Why is complete deregulation, in your expert opinion, not appropriate?

22
23 A10. In this case, the market being served by IHSF and Interstate Navigation is defined as
24 the supply of water-based transportation to New Shoreham. As such, these two firms
25 compete, albeit indirectly, in the sub-market category of seasonal passenger transport
26 from Galilee, Rhode Island to two different ports of call on Block Island based on
27 different schedules. While not direct competitors, the two firms do have some
28 competitive overlap. The extent to which some competitive overlap does exist,
29 however, creates a duopoly market structure. Duopolistic market structures, by their
30 nature, present the opportunity for anti-competitive collusive behavior on the part of
31 the market players. While I believe that the potential for collusive behavior between
32 IHSF and Interstate Navigation is extraordinarily remote, the public interest is best
33 served by some form of very limited regulation of IHSF's rates.

34
35 Q11. Why is rate-based rate of return, in your expert opinion, also not appropriate?

1 A11. Given the fact that the two market players are indirect competitors, rate-based, rate-
2 of-return regulation is not appropriate because of the profoundly different character of
3 the services supplied to the market by IHSF and Interstate Navigation. Interstate
4 Navigation is the essential, lifeline, non-amenities-based transportation supplier that
5 enjoys monopolistic market position with respect to vehicle transport, freight, and
6 passenger ridership required to escort a vehicle. IHSF, on the other hand, is a non-
7 essential, non-lifeline, discretionary, amenities-based transportation supplier which
8 competes directly with a non-regulated airline service, which flies to Block Island
9 from Westerly. Rate-based, rate-of-return regulation is used to regulate traditional
10 utilities where competition is limited or non-existent and where the potential for
11 direct competitive market entrance is remote. IHSF is not a traditional public utility.
12 In my expert opinion, these are compelling reasons why a rate-based, rate-of-return
13 form of regulation would be inappropriate for IHSF.
14

15 Q12. Do you have an opinion, with a reasonable degree of economic certainty, as to what is
16 the appropriate form of regulation for IHSF?
17

18 A12. Yes.
19

20 Q13. What is that opinion?
21

22 A13. I believe that the most appropriate form of regulation for IHSF, for all of the reasons
23 previously discussed, is an alternative (yet pragmatic) form which simply imposes a
24 ticket price floor for passenger ridership only. Specifically, the ticket price floors
25 which are currently in place and the differential which presently exists. With respect
26 to the current differential, I am NOT proposing that a fixed differential be part of the
27 regulation.
28

29 Q14. Could you explain, in detail, the reasons for the form of regulation you are proposing?
30

31 A14. The principal reasons are (1) that IHSF is a non-essential, non-lifeline, discretionary,
32 amenities-based transportation service; (2) that IHSF and Interstate Navigation are
33 indirect competitors; (3) that the role each firm plays in the market is vastly
34 differentiated; (4) the proposed form of regulation preserves the spirit of Division
35 Docket 98-MC-16, which is meant to provide a rate differential sufficient to protect
36 the essential lifeline service (Interstate Navigation) from the potential of “a massive

1 crossing of the dock”; and, (5) that IHSF faces potential competition from new market
2 entrants.

3

4 Q15. Have you reviewed IHSF’s Compliance Report for 2002?

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6 A15. Yes.

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8 Q16. Have you also reviewed the company’s responses to the Commission’s data requests
9 relative to that Compliance Report?

10

11 A16. Yes.

12

13 Q17. Have you also reviewed reports regarding Interstate Navigation’s landing fee
14 payments to the Town of New Shoreham?

15

16 A17. Yes, as published in the Block Island Times.

17

18 Q18. Having reviewed those various documents, do they support your conclusions
19 regarding the appropriateness of the form of regulation that you are proposing for
20 IHSF?

21

22 A18. Yes. There is a complete lack of any significant empirical evidence to suggest that a
23 “massive crossing of the dock” has occurred to the detriment of the essential life-line
24 service provider. This lack of evidence is entirely consistent with prior testimony in
25 Commission Docket 2802 that IHSF, as a new, non-essential, discretionary and
26 amenities-based service provider, would draw its customer base primarily from the
27 activation of a dormant unserved niche market. Additionally, the fact that the
28 essential life-line service provider has not made application for a rate increase,
29 strongly suggests a lack of injury resulting from IHSF operations. There also has
30 been a continuation of the essential life-line service provider’s monopoly with respect
31 to vehicle transport, freight, motorcycles, etc., which has maintained their “captured
32 ridership” market segment.

33

34 Q19. Can you give us an example of where a similar form of “alternative” or “pragmatic”
35 regulation has been approved by the Commission?

36

1 A19. Yes.

2
3 Q20. Could you be more specific?

4
5 A20. First of all, the Rhode Island Supreme Court has approved “alternative” or
6 “pragmatic” ratemaking in its decisions in United States v. Public Utilities
7 Commission, 393 A.2d 1092 (R.I. 1978), and In Re: Island Hi-Speed Ferry, LLC, 746
8 A.2d 1240 (R.I. 2000). The most applicable examples, in my opinion, are the
9 Commission’s decisions in Commission Docket 2802, In Re: Island Hi-Speed Ferry,
10 LLC, and Commission Docket 3445, In Re: Verizon - Rhode Island’s Alternative
11 Regulation Plan.

12
13 Q21. Why is the “alternative” or “pragmatic” approach to regulation and the specific
14 application of the approach to Verizon applicable here?

15
16 A21. The Verizon approach is analogous due to the fact that the Commission recognized
17 that where competition exists with respect to discretionary, non-essential services, an
18 alternative form of regulation was justified. For example, the use of price floors. In
19 this case, IHSF competes indirectly with Interstate Navigation and directly with New
20 England Airlines. IHSF also faces competition from potential market entrants from
21 other points in Rhode Island (e.g., Quonset) or other states.

22
23 Q22. Assuming your proposed form of regulation is adopted by the Commission, in your
24 expert opinion, how will this translate in terms of overall market behavior?

25
26 A22. Choice and competition are vital elements in promoting the public interest, especially
27 when the essential life-line service provider is largely unaffected. Market forces will
28 regulate IHSF’s prices in all other areas which are not related to ticket prices. Market
29 forces will also influence management’s discretion to raise existing passenger rates.
30 An additional protector of the public interest in this regard is the potential for new
31 market entry, which will prevent excess profitability, if it is ever achieved, from being
32 maintained.

33
34 Q23. Does this conclude your testimony?

35
36 A23. Yes.